

## Increases in Risk and in Risk Aversion\*

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Analysis of individual behavior under uncertainty naturally focuses on the meaning and economic consequences of two statements:

1. one situation is riskier than another;
2. one individual is more risk averse than another.<sup>1</sup>

M. Rothschild and J. Stiglitz [12, 13] have considered increases in risk in terms of a change in the distribution of a random variable which keeps its mean constant and represents the movement of probability density from the center to the tails of the distribution.<sup>2</sup> After restating their analysis in Section 1, we consider an alternative definition in which the expectation of utility (rather than the mean of the random variable) is kept constant. Increases in risk ought to "affect" more risk averse individuals more than they do less risk averse individuals. This suggests that appropriate definitions of increases in risk and in risk aversion ought to be closely linked. In Section 3 we examine the concept of increased risk aversion which seems paired with the concept of increased risk and obtain sufficient conditions for the effect of increased risk aversion on choice

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<sup>1</sup> This statement includes the possibility that the two individuals being compared are the same individual with different level of some parameter, such as wealth.

<sup>2</sup> The basic theorem in this area was proved by Hardy, Littlewood, and Polya [5]. For a discussion of the earlier literature see D. Schmeidler [15], Rothschild and Stiglitz [14], and S. Ch. Kolm [7].

to be of determinate sign. This approach follows that of K. Arrow [1] and J. Pratt [11] altered to fit our setting.

The second part of the paper applies these general results to specific problems, obtaining some well known results and some which are, to our knowledge, new.

## 1. MEAN PRESERVING INCREASE IN RISK

### 1.1. Definition

Consider a family of distribution functions,  $F(\theta, r)$  where  $\theta$  is a random variable defined over a finite range. (Without loss of generality we let the range be the unit interval.)<sup>3</sup> Consider two distributions in the family,  $F(\theta, r_1)$  and  $F(\theta, r_2)$ . If  $F(\theta, r_2)$  is derived from  $F(\theta, r_1)$  by taking weight from the center of the probability distribution and shifting it to the tails, while keeping the mean of the distribution constant, it is natural to say that  $F(\theta, r_2)$  represents a riskier situation than  $F(\theta, r_1)$  and that the difference between these two variables is a *mean preserving increase in risk*. Illustrated in Fig. 1 is a simple example of such an increase where the

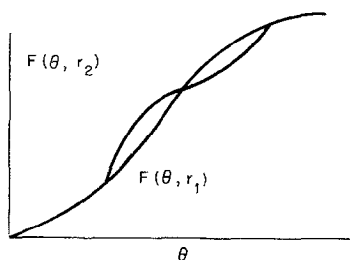


FIGURE 1

two distributions cross only once (so it is unambiguously clear that  $F(\theta, r_2)$  has more weight in both tails). When this situation holds we shall say that the difference between distributions has the *single crossing property* and that the difference represents a *simple mean preserving spread*.

Analytically, we can characterize such a spread by the two conditions

$$\int_0^1 [F(\theta, r_2) - F(\theta, r_1)] d\theta = 0 \quad (1)$$

<sup>3</sup>  $F$  is assumed to be twice continuously differentiable with respect to  $\theta$  and  $r$ . It is unnecessary to specify the range over which  $r$  is defined. When we omit the limits of integration, integration is done over the full range of  $\theta$ .

There exists a  $\hat{\theta}$  such that

$$F(\theta, r_2) - F(\theta, r_1) \leq (\geq) 0 \quad \text{when } \theta \geq (\leq) \hat{\theta} \quad (2)$$

The first condition assures us that the two distributions have the same mean,<sup>4</sup> the second, that there is a single crossing. An immediate implication of (1) and (2) is that the indefinite integral of the difference in the distributions is nonnegative

$$\int_0^y [F(\theta, r_2) - F(\theta, r_1)] d\theta \geq 0 \quad 0 \leq y \leq 1 \quad (3)$$

If we consider another distribution  $F(\theta, r_3)$  generated from  $F(\theta, r_2)$  by a simple mean preserving spread,  $F(\theta, r_3) - F(\theta, r_1)$  does not, in general have the single crossing property, as can be seen in Fig. 2. Since  $F(\theta, r_3)$

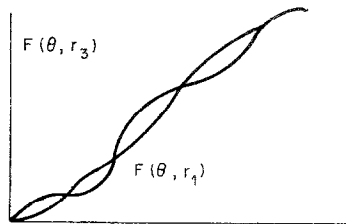


FIGURE 2

is riskier than  $F(\theta, r_2)$  and  $F(\theta, r_2)$  is riskier than  $F(\theta, r_1)$ , we would like to say that  $F(\theta, r_3)$  is riskier than  $F(\theta, r_1)$ . Accordingly, (1) and (2) do not provide an adequate basis for a definition of "riskier." However,  $F(\theta, r_3) - F(\theta, r_1)$  does satisfy conditions (1) and (3), as does the difference after any sequence of such steps. Rothschild and Stiglitz have shown, moreover, that if  $F(\theta, r_3) - F(\theta, r_1)$  satisfies conditions (1) and (3),  $F(\theta, r_3)$  can be generated from  $F(\theta, r_1)$  as a limit of a sequence of simple mean preserving spreads. Thus (1) and (3) provide a natural definition of increased risk.<sup>5</sup>

$$\begin{aligned} & \int \theta \{dF(\theta, r_2) - dF(\theta, r_1)\} \\ &= - \int [F(\theta, r_2) - F(\theta, r_1)] d\theta + \theta [F(\theta, r_2) - F(\theta, r_1)] \Big|_0^1 = 0 \end{aligned}$$

applying integration by parts, Eq. (1) and the obvious properties  $F(0, r_2) = F(0, r_1) = 0$  and  $F(1, r_2) = F(1, r_1) = 1$ .

<sup>5</sup> Rothschild and Stiglitz [12] have also shown that this definition of increased risk is equivalent to two other definitions: that all risk averters dislike increased risk, and that an increase in risk is the addition of noise to a random variable.

In the subsequent discussion, we shall compare members of the family of distributions which are "close" to each other. We shall then say that an increase in  $r$  (the "shift parameter") represents a mean preserving increase in risk if

$$\int_0^1 F_r(\theta, r) d\theta = 0 \quad (4)$$

and

$$T(y, r) = \int_0^y F_r(\theta, r) d\theta \geq 0 \quad 0 \leq y \leq 1 \quad (5)$$

## 1.2. Consequences

To consider the consequences of increased risk Rothschild and Stiglitz considered an expected utility maximizing individual whose utility depends on a random variable,  $\theta$ , and a control variable,  $\alpha$ <sup>6</sup>

$$U = U(\theta, \alpha) \quad (6)$$

with the assumption  $U_{\alpha\alpha} < 0$ . We also assume that  $U_\theta > 0$ .<sup>7</sup> Then, they related the optimal level of  $\alpha$  to increases in risk. In a form which will be useful for later analysis we can state their results as

**THEOREM 1.** *Let  $\alpha^*(r)$  be the level of the control variable which maximizes  $\int U(\theta, \alpha) dF(\theta, r)$ . If increases in  $r$  represent mean preserving increases in risk (i.e., satisfy (4) and (5)), then  $\alpha^*$  increases (decreases) with  $r$  if  $U_\alpha$  is a strictly convex (concave) function of  $\theta$ , i.e., if  $U_{\alpha\theta\theta} > (<) 0$ .<sup>8</sup>*

<sup>6</sup>  $U$  is assumed to be a thrice continuously differentiable function of  $\theta$  and  $\alpha$ .

<sup>7</sup> For many problems the positivity of  $U_\theta$  for all  $\alpha$  will follow naturally, as with investment with a random return. However, with the possibility of short sales  $U_\theta$  may be positive for some  $\alpha$  and negative for others depending on the position taken by the investor. Also  $U_\theta$  may not be of one sign for a given  $\alpha$ .

<sup>8</sup> *Proof.*  $\alpha^*(r)$  is defined implicitly by the first order condition for expected utility maximization

$$\int U_{\alpha}(\theta, \alpha) F_{\theta}(\theta, r) d\theta = 0$$

Implicitly differentiating, we have

$$d\alpha^*/dr = - \left[ \int U_{\alpha} F_{\theta r} d\theta \right] / \left[ \int U_{\alpha\alpha} F_{\theta} d\theta \right]$$

Since the denominator is negative  $d\alpha^*/dr$  has the same sign as the numerator. Applying integration by parts twice (and noting that  $F_r(0, r) = F_r(1, r) = T(0, r) = T(1, r) = 0$ ) we have

$$\int U_{\alpha} F_{\theta r} d\theta = - \int U_{\alpha\theta} F_r d\theta = \int U_{\alpha\theta\theta} T(\theta, r) d\theta$$

where  $T$  was defined in (5) and by assumption is nonnegative so that  $d\alpha^*/dr$  has the same sign as  $U_{\alpha\theta\theta}(\alpha, \theta)$ , assuming that  $U_{\alpha\theta\theta}(\alpha, \theta)$  is uniformly signed for all  $\theta$ . ||

This theorem represents a complete characterization in the sense that changes in distributions not satisfying the definition of increasing risk can lead to decreases (increases) in  $\alpha^*$  despite the convexity (concavity) of  $U_\alpha$  (and, obviously, in the absence of convexity (concavity) of  $U_\alpha$  increases in risk can lead to decreases (increases) in  $\alpha^*$ ).

The approach of the next section will be to explore a similar analysis where increases in risk keep the mean of utility constant rather than the mean of the random variable. This is an advantage since some economic variables can naturally be described in several ways. For example, we could describe the consumption possibilities arising from a short term investment in a consol in terms of the interest rate or in terms of the future price of the consol. A change in riskiness of the investment which kept expected price constant will not keep the expected interest rate constant. Alternatively in an international trade setting with one export good, one import good, and uncertain terms of trade, increases in the riskiness of trade keeping the expected import price constant (with export price as numeraire) do not keep the expected export price constant (with import price as numeraire). More generally if we have a new random variable  $\hat{\theta}$ , monotonically related to the original random variable,  $\hat{\theta} = \psi(\theta)$ , then a change in the distribution of  $\theta$  keeping its mean constant will generally change the mean of  $\hat{\theta}$ . In addition marginal utility of the control variable as a function of  $\hat{\theta}$

$$\hat{U}_\alpha(\hat{\theta}, \alpha) = U_\alpha(\psi^{-1}(\hat{\theta}), \alpha) \quad (7)$$

may not have the appropriate curvature to apply Theorem 1 to changes in the distribution of  $\hat{\theta}$ , even if it is well behaved relative to  $\theta$ . By considering utility as the random variable, we obtain results which do not depend on the formulation of the problem in terms of  $\theta$  rather than  $\hat{\theta}$ .

## 2. MEAN UTILITY PRESERVING INCREASE IN RISK

### 2.1. Definition

Let us denote by  $\hat{F}(u, \alpha, r)$  the distribution of  $U(\theta, \alpha)$  induced by the distribution  $F(\theta, r)$  when  $\alpha$  is chosen; and by  $\alpha^*(r)$ , the optimal level of the control variable. (Without loss of generality, we can normalize  $u$  so that it varies over the unit interval as  $\theta$  does.) Then, we will say that increases in  $r$  correspond to mean utility preserving increases in risk if<sup>9</sup>

$$\hat{T}(y, r) = \int_0^y \hat{F}_r(u, \alpha^*(r), r) du \geq 0 \quad \text{for all } y \quad (8)$$

<sup>9</sup> The yield-compensated change in risk of a security, considered by P. Diamond and M. Yaari [3] is an example of a mean utility preserving increase in risk.

and

$$\tilde{T}(1, r) = \int_0^1 \tilde{F}_r(u, \alpha^*(r), r) du = 0 \quad (9)$$

Since we assumed  $U_\theta > 0$ , it is easy to relate the two definitions of increased riskiness. For any levels of  $u$  and  $\alpha$  there is a unique level of  $\theta$ , which we denote by  $U^{-1}(u, \alpha)$ , which is defined by  $u = U(\theta, \alpha)$ . For any  $\alpha$ , the distributions of  $u$  and of  $\theta$  are now related by

$$\tilde{F}(U(\theta, \alpha), \alpha, r) = F(\theta, r) \quad (10)$$

or equivalently

$$\tilde{F}(u, \alpha, r) = F(U^{-1}(u, \alpha), r) \quad (11)$$

By a change of variable we can now restate the conditions making up the definition of mean utility preserving increase in risk as

$$\tilde{T}(y, r) = \int_0^y U_\theta F_r(\theta, r) d\theta \geq 0 \quad \text{for all } y \quad (12)$$

$$\tilde{T}(1, r) = \int_0^1 U_\theta F_r(\theta, r) d\theta = 0 \quad (13)$$

(See Fig. 3 for an example of the relationship between  $F$  and  $\tilde{F}$ .) As with the mean preserving increase, condition (12) reflects a risk increase which is equivalent to the limit of a sequence of steps taking weight from the center of the probability distribution and shifting it to the tails. Now, however, expected utility, rather than the mean of the random variable is held constant. Thus it is natural to think of the mean utility preserving increase as a "compensated" adjustment of a mean preserving increase in risk.<sup>10</sup>

## 2.2. Consequences

We can now turn to the analogue to Theorem 1 for this type of change in risk. We expect to find that the critical condition is the concavity of

<sup>10</sup> For arbitrary changes in the distribution of  $\theta$  one can consider dividing the total change in a fashion analogous to the Slutsky equation. Thus one would subtract a change in the distribution which had the same impact on expected utility, leaving a mean utility preserving change, which might have a signed impact on  $\alpha$  if it represents an increase in risk. The subtracted change could be divided into income and substitution effects. This approach was taken by Diamond [2].

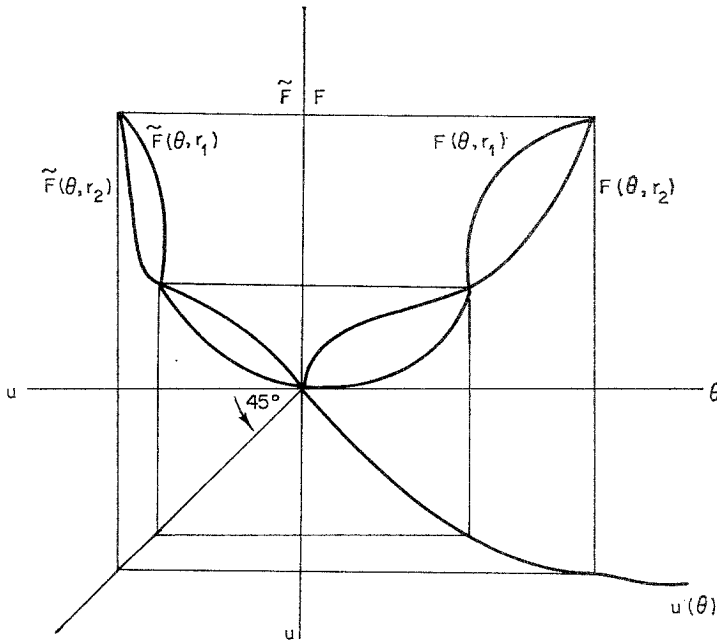


FIGURE 3

$U_\alpha$  as a function of  $u$  rather than  $\theta$ . Differentiating  $U_\alpha(U^{-1}(u, \alpha), \alpha)$  with respect to  $u$  we have

$$\frac{\partial U_\alpha}{\partial u} = \frac{U_{\alpha\theta}}{U_\theta} \quad \frac{\partial^2 U_\alpha}{\partial u^2} = \frac{U_{\alpha\theta\theta}}{U_\theta^2} - \frac{U_{\alpha\theta}U_{\theta\theta}}{U_\theta^3} = \frac{1}{U_\theta} \left( \frac{\partial^2 \log U_\theta}{\partial \theta \partial \alpha} \right) \quad (14)$$

**THEOREM 2.<sup>11</sup>** Let  $\alpha^*(r)$  be the level of the control variable which maximizes  $\int U(\theta, \alpha) dF(\theta, r)$ . If increases in  $r$  represent mean utility preserving increases in risk (i.e., satisfy (12) and (13)) then  $\alpha^*$  increases (decreases) with  $r$  if  $U_\alpha$  is a strictly convex (concave) function of  $u$ , or

$$\frac{U_\theta U_{\alpha\theta\theta} - U_{\alpha\theta} U_{\theta\theta}}{U_\theta} > (<) 0 \quad (15)$$

*Proof.*<sup>12</sup> By implicit differentiation of the first order condition,

$$\int U_\alpha dF = 0, \quad \frac{d\alpha^*}{dr} = \frac{\int U_\alpha dF_r}{-\int U_{\alpha\alpha} dF}$$

<sup>11</sup> The theorem is also valid for a discrete change in riskiness such that expected utilities at the respective optima are equal. Since expected marginal utility is decreasing in the control variable ( $U_{\alpha\alpha} < 0$  is assumed) the proof follows from determining the sign of  $\int U_\alpha(\theta, \alpha(r_1)) dF(\theta, r_2)$  in a parallel fashion to the proof given.

<sup>12</sup> An alternate proof can be constructed by substituting  $U^{-1}(u, \alpha)$  for  $\theta$  in the first order condition and applying the proof of Theorem 1.

Thus the sign of  $d\alpha^*/dr$  is the same as the sign of  $\int U_\alpha dF_r (= \int U_\alpha F_{\theta r} d\theta)$ . Applying integration by parts twice and noticing that

$$F_r(0, r) = F_r(1, r) = \tilde{T}(0, r) = \tilde{T}(1, r) = 0$$

we have

$$\begin{aligned} \int U_\alpha F_{\theta r} d\theta &= - \int U_{\alpha\theta} F_r d\theta = - \int \frac{U_{\alpha\theta}}{U_\theta} U_\theta F_r d\theta \\ &= \int \frac{U_\theta U_{\alpha\theta\theta} - U_{\alpha\theta} U_{\theta\theta}}{U_\theta^2} \tilde{T} d\theta \parallel \end{aligned}$$

This theorem represents a complete characterization in this case in the same sense that Theorem 1 did for mean preserving increases.

From the two theorems, we see that a uniform sign of  $U_{\alpha\theta\theta}$  will sign the response of  $\alpha$  to a mean preserving change in risk while a uniform sign of  $U_\theta U_{\alpha\theta\theta} - U_{\alpha\theta} U_{\theta\theta}$  will sign the response of  $\alpha$  to a mean utility preserving change in risk. In the next section we will develop a notion of increases in risk aversion, which will allow us to interpret Theorem 2 as stating that the *optimal response to a mean utility preserving increase in risk is to adjust the control variable so as to make  $U$  show less risk aversion.*

### 2.3. Choice of a Distribution

The basis of Theorem 2 is a set of sufficient conditions for signing the second derivative of expected utility with respect to  $\alpha$  and  $r$ . Since the order of differentiation doesn't matter, reversal of the role of  $\alpha$  and  $r$ , i.e., making  $\alpha$  the "shift" parameter and  $r$  the control, still results in a sign-determined effect of shift variable on control variable.<sup>13</sup> Thus let us consider a situation where individuals select the distribution function of income (as when they select a career) and where the choice problem is parametrized by a variable which may reflect differences across people (such as risk aversion) or a level of some exogenous variable (such as the income tax rate). If distributions can be classed by riskiness (in the sense of the integral condition (12) or the single crossing property) and the shift parameter enters the utility function suitably we can sign the effect of the shift parameter (risk aversion or income tax rate, say) on the riskiness of selected careers.

More formally we consider an individual with utility function  $U(\theta, \alpha)$  selecting among a family of distributions,  $F(\theta, r)$  to maximize expected utility.

$$\max_r \int U(\theta, \alpha) dF(\theta, r)$$

<sup>13</sup> This interpretation was suggested by James Mirrlees.



The first order condition for this maximization is

$$\int U(\theta, \alpha) dF_r(\theta, r^*) = - \int U_\theta F_r d\theta = - \int \tilde{F}_r du = 0 \quad (16)$$

To apply the analysis of Theorem 2, we must be able to show that  $F_r(\theta, r^*)$  satisfies (12) and (13). (13) is equivalent to the first order condition (16). (12) may be verified in the context of any particular problem; for the examples we have considered, one can readily verify the stronger single crossing property. Thus we state this result as:

**COROLLARY.** *Let  $r^*(\alpha)$  be the level of the control variable which maximizes  $\int U(\theta, \alpha) dF(\theta, r)$ . If there exists a  $\hat{\theta}$  such that*

$$F_r(\theta, r^*)(\theta - \hat{\theta}) \leq 0 \quad \text{for all } \theta$$

*then  $r^*$  increases (decreases) with  $\alpha$  if  $\partial^2(\log U_\theta)/\partial\theta \partial\alpha$  is everywhere positive (negative).*

### 3. GREATER AVERSION TO RISK

#### 3.1. Definition

Consider a mean utility preserving increase in risk for an individual. If a second individual finds his expected utility decreasing from this change for any mean utility preserving increase in risk for the first individual, it is natural to say that the second individual is more risk averse than the first. It is also natural to say that a more risk averse individual will pay more for perfect insurance against any risk. Fortunately, as with riskiness, the different natural definitions of increased risk aversion are equivalent and lend themselves to an analysis of differences in behavior as a result of differences in risk aversion (either across individuals or as a result of a parameter change for a given individual). For some of our purposes it is convenient to work with a differentiable family of utility functions,  $U(\theta, \rho)$ , where  $\rho$  represents an ordinal index of risk aversion. Given this notation we shall start by considering four equivalent definitions of increased risk aversion. Numbers two through four are, in our notation and setting, three of the five definitions which Pratt [11] showed to be equivalent. The inference of number one from the others is due to H. Leland [8].

<sup>14</sup> For the present, we suppress the role of the control variable  $\alpha$ . In some problems it will not appear. In others we can apply Theorem 3 for a given level of  $\alpha$ .

**THEOREM 3.** *The following definitions of the family of utility functions  $U(\theta, \rho)$  showing increasing risk aversion with the index  $\rho$  are equivalent.<sup>15</sup>*

(i) *Mean utility preserving increases in risk are disliked by the more risk averse, i.e., for any change in a distribution of  $\theta$ ,  $F_r \neq 0$  satisfying*

$$\tilde{T}(y, r) = \int_0^y U_\theta(\theta, \rho) F_r(\theta, r) d\theta \geq 0 \quad \text{for all } y$$

*and*

$$\tilde{T}(1, r) = \int_0^1 U_\theta(\theta, \rho) F_r(\theta, r) d\theta = 0$$

*we have*

$$\int_0^1 U_\rho(\theta, \rho) F_{\theta r}(\theta, r) d\theta < 0; \quad (17)$$

(ii) *For any risk, the risk premium for perfect insurance increases with risk aversion, i.e. for any  $F$ ,  $p(\rho)$  defined by*

$$U\left(\int \theta dF - p(\rho), \rho\right) = \int U(\theta, \rho) dF \quad (18)$$

*$p'(\rho) > 0$ ;*

(iii) *The index of risk aversion increases with  $\rho$ , i.e.,*

$$-\partial^2 \log U_\theta / \partial \theta \partial \rho > 0; \quad (19)$$

(iv) *For each pair  $(\rho_1, \rho_2)$  with  $\rho_1 > \rho_2$ , there exists a monotone concave function  $\phi$ ,*

$$\phi' > 0, \quad \phi'' < 0$$

*such that*

$$U(\theta, \rho_1) = \phi(U(\theta, \rho_2)) \quad (20)$$

*Proof.* (i)  $\Leftrightarrow$  (iii) Applying integration by parts to (17) (and recalling that  $F_r(0, r) = F_r(1, r) = \tilde{T}(0, r) = \tilde{T}(1, r) = 0$ ) we have

$$\begin{aligned} \int U_\rho F_{\theta r} d\theta &= - \int U_{\theta \rho} F_r d\theta = - \int \frac{U_{\theta \rho}}{U_\theta} U_\theta F_r d\theta \\ &= \int \frac{\partial^2 \log U_\theta}{\partial \theta \partial \rho} \tilde{T}(\theta, r) d\theta \end{aligned} \quad (21)$$

<sup>15</sup> We ignore complications in the statement of these conditions arising on sets of values of  $\theta$  of measure zero.

The negativity of  $\partial^2 \log U_\theta / \partial \theta \partial \rho$  and positivity of  $\tilde{T}$  imply (17). Conversely, since any nonnegative  $\tilde{T}$  is admissible positive values for the second derivative would permit a positive value for (17).

(iii)  $\Leftrightarrow$  (iv) Differentiating (20) with respect to  $\theta$  we have

$$\begin{aligned} U_\theta(\theta, \rho_1) &= \phi' U_\theta(\theta, \rho_2) \\ U_{\theta\theta}(\theta, \rho_1) &= \phi'' U_\theta^2(\theta, \rho_2) + \phi' U_{\theta\theta}(\theta, \rho_2) \end{aligned}$$

or solving for  $\phi''$ :

$$\begin{aligned} \phi'' &= \left( \frac{U_{\theta\theta}(\theta, \rho_1)}{U_\theta(\theta, \rho_1)} - \frac{U_{\theta\theta}(\theta, \rho_2)}{U_\theta(\theta, \rho_2)} \right) \frac{U_\theta(\theta, \rho_1)}{U_\theta^2(\theta, \rho_2)} \\ &= \left[ \int_{\rho_2}^{\rho_1} (\partial^2 \log U_\theta / \partial \theta \partial \rho) d\rho \right] \frac{U_\theta(\theta, \rho_1)}{U_\theta^2(\theta, \rho_2)} \end{aligned} \quad (22)$$

The negativity of  $\phi''$  follows from the integration. Conversely, a contradiction of (19) over a range of  $\rho$  would contradict  $\phi'' < 0$ .

(ii)  $\Leftrightarrow$  (iii) Calculating  $p(\rho)$  by implicit differentiation of (18).

$$p'(\rho) = \frac{(U_\theta (\int \theta dF - p(\rho), \rho) - \int U_\theta(\theta, \rho) dF)}{U_\theta} \quad (23)$$

Define

$$F(\theta, r^*) = \begin{cases} 0 & \text{for } 0 \leq \theta \leq \int_0^1 \theta dF - p \\ 1 & \text{for } \int_0^1 \theta dF - p < \theta \leq 1 \end{cases}$$

$F(\theta, r^*)$  is the (improper) distribution of the safe prospect which yields the same (expected) utility as the risky distribution  $F(\theta, r)$ ; hence<sup>16</sup> from the definition of  $F(\theta, r^*)$

$$\tilde{T}(\theta, r) \equiv \int_0^\theta U_\theta(F(\theta, r) - F(\theta, r^*)) d\theta \geq 0 \quad \text{for } 0 \leq \theta \leq 1 \quad (24)$$

and

$$\int_0^1 U_\theta(F(\theta, r) - F(\theta, r^*)) d\theta = 0 \quad (25)$$

<sup>16</sup> We defined  $\tilde{T}(\theta, r)$  above (Eq. (8)) for differential changes in  $r$ . The change from  $F(\theta, r)$  to  $F(\theta, r^*)$  is not a "small change." Since the RHS of (24) and (25) are perfectly analogous to the RHS of (8) and (9), we shall use the same symbol  $\tilde{T}$ .

We can now calculate

$$\begin{aligned}
 U_\rho - \int U_\rho dF(\theta, r) &\equiv \int U_\rho [dF(\theta, r^*) - dF(\theta, r)] \\
 &= - \int U_{\rho\theta} [F(\theta, r^*) - F(\theta, r)] d\theta \\
 &= - \int \frac{U_{\rho\theta}}{U_\theta} U_\theta [F(\theta, r^*) - F(\theta, r)] d\theta \\
 &= \int \frac{\partial^2 \log U_\theta}{\partial \theta \partial \rho} \tilde{T}(\theta, r) d\theta \quad (26)
 \end{aligned}$$

The equivalence follows from (26) since  $\tilde{T}$  is nonnegative and any distribution  $F$  is admissible. ■

It is interesting to note that (iii) permits us to conclude that with suitable normalization to keep the mean of  $\log U_\theta$  constant the more risk averse individual has a riskier distribution of  $\log U_\theta$ , since the monotonicity of  $\partial \log U_\theta / \partial \theta$  in  $\rho$  implies the single crossing property. This result fits with the observation that someone who is risk neutral has a constant marginal utility, implying that a risk averse person (or a risk lover) has greater variation in his marginal utility.

If we think of people choosing careers as choosing a distribution of possible incomes and if the income streams for different careers have the single crossing property, the definition of risk aversion permits us to interpret the corollary to Theorem 2 as saying that more risk averse people choose less risky careers. This result is interesting only as a confirmation of the matching of the definitions of risk and risk aversion.

The formulation of the definitions of risk aversion are structured to cover the familiar single argument utility function, or the appearance of a single random variable in a many argument utility function. For example the two period consumption model with known wages falls within this formulation, since the only random variable is the rate of return. In making comparisons between utility functions of several arguments, one approach is to examine individuals who differ only in their degree of risk aversion, that is, to assume that the two individuals being compared have the same indifference curves between random and control variables denoted by  $\theta$  and  $\alpha$  respectively. (These may be vectors rather than scalars as in this analysis.) Thus we have increased risk aversion if there is a monotone concave function  $\phi$  so that

$$U^1(\theta, \alpha) = \phi(U^2(\theta, \alpha)) \quad (27)$$

Considering a family of utility functions indexed by  $\rho$ , the requirement

of identical indifference curves implies that we can write the family of functions  $V(\theta, \alpha, \rho)$  in the separable form  $V(U(\theta, \alpha), \rho)$ . The concavity condition gives us a derivative property (analogous to (19)).

$$\partial^2 \log V_U / \partial U \partial \rho < 0 \quad (28)$$

for risk aversion to increase with  $\rho$ .<sup>17</sup>

### 3.2. Consequences

The analysis above, which showed the close relationship between increased risk and increased risk aversion, suggests the possibility of an analogue to Theorem 2 relating changes in the control variable to increased risk aversion rather than increased riskiness.

**THEOREM 4.** *Let  $\alpha^*(\rho)$  be the level of the control variable which maximizes  $\int V(U(\theta, \alpha), \rho) dF(\theta)$ . If increases in  $\rho$  represent increases in risk aversion (i.e., satisfy (19)), then  $\alpha^*$  increases (decreases) with  $\rho$  if there exists a  $\theta^*$  such that  $U_\alpha \geq (\leq) 0$  for  $\theta \leq \theta^*$  and  $U_\alpha \leq (\geq) 0$  for  $\theta \geq \theta^*$ .*

*Proof.* The first order condition for optimality is

$$\int V_U U_\alpha dF = 0$$

By implicit differentiation we have

$$d\alpha^*/d\rho = - \left[ \int V_{U\rho} U_\alpha dF \right] / \left[ \int (V_{UU} U_\alpha^2 + V_{U\alpha\alpha}) dF \right] \quad (29)$$

Concavity of  $V$  in  $\alpha$  implies that the sign of  $d\alpha^*/d\rho$  is the same as that of  $\int V_{U\rho} U_\alpha dF$ . Multiplying and dividing by  $V_U$  and adding a constant times the first order condition, we have

$$\int V_{U\rho} U_\alpha dF = \int \left( \frac{V_{U\rho}(U(\theta, \alpha), \rho)}{V_U(U(\theta, \alpha), \rho)} - \frac{V_{U\rho}(U(\theta^*, \alpha), \rho)}{V_U(U(\theta^*, \alpha), \rho)} \right) V_U U_\alpha dF \quad (30)$$

The integrand is everywhere positive (negative) since both terms change sign just once at  $\theta^*$ . ■

The mathematical parallel between Theorems 2 and 4 is most clearly brought out by considering the former for an increase in risk which has

<sup>17</sup> Given our assumption that  $U_\theta$  is positive, this does not represent a change in conditions since  $\partial^2 \log V_\theta / \partial \theta \partial \rho = U_\theta \partial^2 \log V_U / \partial U \partial \rho$ . Thus (28) is equivalent to  $\int V_\rho F_{\theta\rho} d\theta < 0$  and  $p'(\rho) > 0$  where  $V(U(\int \theta dF - p, \alpha), \rho) = \int V(U(\theta, \alpha), \rho) dF$ .

the single crossing property. Plotting the two terms to be multiplied in the integrand to sign the numerator we have

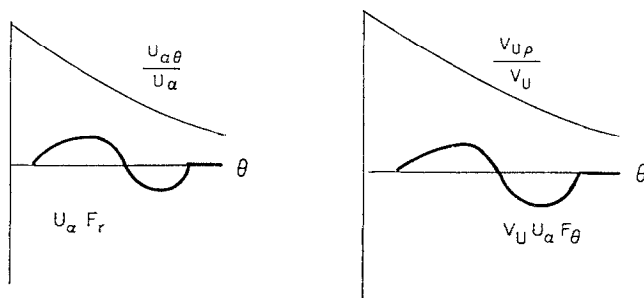


FIGURE 4

The result follows from the monotonicity of  $(U_{\alpha\theta}/U_{\alpha})$ , resp.  $(V_{U\rho}/V_U)$  and the fact that  $U_{\alpha}F_r$  resp.  $(V_U U_{\alpha}F_{\theta})$  integrates to zero with a single sign change.<sup>18</sup>

Pursuing the parallel between the proofs, we could integrate the numerator in (29) by parts before seeking a sufficient condition to sign the expression:

$$\int V_{U\rho} U_{\alpha} dF = \int (V_{U\rho}/V_U) V_U U_{\alpha} dF = - \int (\partial^2 \ln V_U / \partial \rho \partial \theta) \hat{T}(\theta, r) d\theta \quad (31)$$

where  $\hat{T}(\theta, r) = \int_0^{\theta} V_U U_{\alpha} dF$  and using a normalization of  $V$  to preserve expected marginal utility in a similar fashion to the analysis in the previous section. We could now replace the single crossing property in Theorem 4 by the nonnegativity of  $\hat{T}$ . However, if the single crossing property is not satisfied by the utility function the integral condition depends on the distribution of  $\theta$  as well as the properties of  $V$  (and can be reversed in sign for some distribution of  $\theta$ ). In addition we have not found applications for this more general assumption.<sup>19</sup>

The single crossing property of  $U_{\alpha}$  as a function of  $\theta$  may be satisfied from a variety of alternative assumptions on the structure of the choice problem. One way of ensuring a single crossing is to have  $U_{\alpha\theta}$  uniformly signed at  $U_{\alpha} = 0$ . Given continuity, two crossings would necessarily have opposite slopes. If we consider the certainty problem where  $\theta$  is a parameter, then the sign of  $U_{\alpha\theta}$  when  $U_{\alpha} = 0$  is the same as the sign of

<sup>18</sup> This proof points up the fact that the corollary to Theorem 2 is also derivable as a corollary to Theorem 4, letting utility,  $U$ , be the random variable, which implies that the control variable,  $\alpha$ , affects the distribution of the random variable.

<sup>19</sup> This is the same situation as with the corollary to Theorem 2.

the derivative of the optimal level of the control variable with respect to the parameter  $\theta$ .<sup>20</sup>

**COROLLARY.** *Let  $\hat{\alpha}(\theta)$  be the level of the control variable which maximizes  $U(\alpha, \theta)$ . Let  $\alpha^*(\rho)$  be the level of the control variable which maximizes  $\int V(U(\alpha, \theta), \rho) dF(\theta)$ . If increases in  $\rho$  represent increases in risk aversion (i.e., satisfy (19)), then  $\alpha^*$  increases (decreases) with  $\rho$  if  $\hat{\alpha}$  decreases (increases) with  $\theta$ .*

The corollary can be connected with the notion of a risk premium. Theorem 3 established that more risk averse individuals have larger risk premiums. If we describe any action under uncertainty as if it were made under certainty with risk premiums deducted from the expected return, then we would expect increased risk aversion to have the same effect as a decreased rate of return in the certainty problem. This is precisely the result in the above corollary. For example, if, under certainty, savings decrease with the interest rate, then with a single risky asset, savings increase with risk aversion.<sup>21</sup>

#### 4. MEASURES OF RISK AVERSION

Three measures of risk aversion have received attention in the literature. We shall relate these to Theorem 3 by examining the circumstances under which a variable can serve as an index of risk aversion as defined in that theorem. For different problems this will coincide with assumptions about these measures of risk aversion. Following Menezes and Hanson [9], we shall call them measures of absolute ( $A$ ), relative ( $R$ ) and partial ( $P$ ) risk aversion<sup>22</sup> and define them for a utility function  $B(x)$  as

$$\begin{aligned} A(x) &= -B''(x)/B'(x) \\ R(x) &= -xB''(x)/B'(x) \\ P(x, y) &= -xB''(x+y)/B'(x+y) \end{aligned} \quad (32)$$

<sup>20</sup> We are indebted to R. Khilstrom and L. Mirman for pointing out a deficiency in our earlier proof.

<sup>21</sup> The optimal savings problem is the maximization of the expectation of the two-period utility function  $B(C, (w - C)(1 + i))$  where  $w$  is initial wealth,  $C$  current consumption and  $i$  the (random) interest rate.

<sup>22</sup>  $A$  and  $R$  were introduced by Arrow [1] and Pratt [11].  $P$  was introduced by C. Menezes and D. Hanson [9] whose approach and notation we follow and whose results we relate to our approach, and by R. Zeckhauser and E. Keeler [17].

They are related by the equation

$$P(x, y) = R(x + y) - yA(x + y) \quad (33)$$

The key ingredient in the analysis<sup>23</sup> is whether the measures increase or decrease in  $x$ . Differentiating the definitions we have

$$\begin{aligned} A'(x) &= -(B'(x))^{-2} (B'(x) B''(x) - (B''(x))^2) \\ R'(x) &= -B''(x)/B'(x) - x(B'(x))^{-2} (B'(x) B''(x) - (B''(x))^2) \\ P_x(x, y) &= -B''(x + y)/B'(x + y) - x(B'(x + y))^{-2} \\ &\quad \times (B'(x + y) B''(x + y) - (B''(x + y))^2) \end{aligned} \quad (34)$$

with the obvious relationship

$$P_x(x, y) = R'(x + y) - yA'(x + y) \quad (35)$$

Since the assumption of an increasing, concave utility function has no sign implications on the third derivative of the utility functions over a finite range, it is clear that absolute risk aversion may increase or decrease. The same is true for the other indices only if  $x$  does not assume the value zero. This is not a restriction for relative risk aversion, since most problems are set up to exclude zero consumption. It does represent a restriction on partial risk aversion since the first order condition for many problems will require  $x$  to take on both positive and negative values.

To relate the three measures of risk aversion to the analysis of Section 3, we must consider some specific problem and select some variable of the problem to serve as an index of risk aversion. For differently structured problems the sign conditions on the index of risk aversion ( $\partial^2 \log U_\theta / \partial \theta \partial \rho$ ) will be equivalent to an increasing or decreasing measure of risk aversion for one of the three measures. To relate the three expressions in (34) to our index we can ask what interaction between  $\theta$  and  $\rho$  will yield a one signed derivative in (34) for a one signed index of risk aversion. By straightforward calculation one can check the three formulations

$$\left\{ \begin{aligned} U(\theta, \rho) &= B(\theta + \rho) \\ U(\theta, \rho) &= B(\theta \rho) \\ U(\theta, \rho) &= B(y + \theta \rho) \end{aligned} \right\} \quad (36)$$

Thus we can conclude that absolute risk aversion increases when leftward translation of the axis corresponds to a concave transform of the utility

<sup>23</sup> The measures indicate aversion to small risks at a given point. To evaluate responses to a large risk, we need assumptions on the measures throughout the relevant range of income.



function. Similarly relative risk aversion increases when multiplicative stretching of the axis (about the origin) corresponds to a concave transform. Increasing partial risk aversion corresponds to a concave transform for a multiplicative transform of the axis beyond the value  $y$ .

To illustrate the role of the measures of risk aversion, let us examine Theorem 3 which showed that an increasing index of risk aversion was equivalent to an increased risk premium. The definition of the risk premium was

$$\int U(\theta, \rho) dF = U\left(\int \theta dF - p(\rho), \rho\right) \quad (37)$$

We shall examine the relationship of the risk premium to initial wealth and the size of the gamble,  $z$ . For this purpose we define the risk premium alternatively as

$$\int U(w + z) dF(z) = U\left(w + \int z dF(z) - \pi(w, z)\right)$$

or

$$-\pi(w, z) = U^{-1}\left(\int U(w + z) dF(z)\right) - \int z dF - w \quad (38)$$

To take advantage of the special forms of the family of utility functions, we can allow the index to affect just wealth, or wealth and the size of the gamble, or just the size of the gamble.

For these formulations (Eq. 36) respectively we make the three substitutions

$$\left\{ \begin{array}{l} z \text{ for } \theta, \rho w \text{ for } \rho \\ w + z \text{ for } \theta \\ z \text{ for } \theta, w \text{ for } y \end{array} \right\} \quad (39)$$

Substituting in the definition of the risk premium (37) for the three formulations we have

$$\left\{ \begin{array}{l} \int B(z + \rho w) dF(z) = B\left(\int z dF(z) - p(\rho) + w\rho\right) \\ \int B((w + z)\rho) dF(z) = B\left(\left(w + \int z dF(z) - p(\rho)\right)\rho\right) \\ \int B(w + \rho z) dF(z) = B\left(w + \left(\int z dF(z) - p(\rho)\right)\rho\right) \end{array} \right\} \quad (40)$$

Solving these three equations for  $p(\rho)$  we have

$$\left\{ \begin{array}{l} -p(\rho) = B^{-1} \left( \int B(z + \rho w) dF \right) - \int z dF - w\rho \\ -\rho p(\rho) = B^{-1} \left( \int B((w + z) \rho) dF \right) - \int \rho z dF - w\rho \\ -\rho p(\rho) = B^{-1} \left( \int B(w + \rho z) dF \right) - \int \rho z dF - w \end{array} \right\} \quad (41)$$

Comparing (41) and (38) we can relate the risk premium as a function of wealth and gamble size to its definition in terms of the risk index

$$p(\rho) = \begin{cases} \pi(\rho w, z) \\ \pi(\rho w, \rho z)/\rho \\ \pi(w, \rho z)/\rho \end{cases} \quad (42)$$

Thus, by Theorem 3 we have shown that

$$\begin{aligned} \partial \pi(\rho w, z)/\partial \rho &\geq 0 & \text{as } A'(x) &\geq 0 \\ \partial (\pi(\rho w, \rho z)/\rho)/\partial \rho &\geq 0 & \text{as } R'(x) &\geq 0 \\ \partial (\pi(w, \rho z)/\rho)/\partial \rho &\geq 0 & \text{as } P_x(x, w) &\geq 0 \end{aligned} \quad (43)$$

With these definitions we can examine further the two examples considered above. Where career choice gives a ranking of the implied income distributions by riskiness, an increase in the rate of a proportional income tax increases (decreases) the riskiness of the chosen careers if relative risk aversion is increasing (decreasing).<sup>24</sup> Considering the special case of savings with a single risky asset where the utility function is additive,<sup>25</sup>  $B_1(C) + B_2(W - C)(1 + i)$ , a mean utility preserving increase in risk increases (decreases) savings as relative risk aversion in period 2,  $xB_2''(x)/B_2'(x)$ , is decreasing (increasing) with consumption.<sup>26</sup>

<sup>24</sup> Choice of a career,  $r$ , is made to maximize  $\int B((1 - t)\theta)dF(\theta, r)$  where  $t$  is the tax rate and  $\theta$ , before tax income. Identifying  $t$  with  $\alpha$  in the corollary to Theorem 2 gives the result. This result appears in M. S. Feldstein [4].

<sup>25</sup> The result only requires that attitudes toward risk in each period be independent of the level of consumption in the other period. This situation has been described by R. Keeney [6] and R. Pollack [10] and requires a utility function of the form  $B(x_1, x_2) = C_0 + b_1 C_1(x_1) + b_2 C_2(x_2) + b_3 C_1(x_1)C_2(x_2)$ .

<sup>26</sup> The simplicity of this result should be contrasted with consideration of the mean preserving increase in risk in this problem. See Rothschild and Stiglitz [13].

## 5. PORTFOLIO CHOICE

The problem which has received the most attention in this general area is the division of a given initial wealth between safe and risky assets. Denoting initial wealth, security holdings, and the rate of return on the safe and risky assets by  $w$ ,  $s$ ,  $m$  and  $i$ , we can write utility as

$$B(w(1 + m) + s(i - m))$$

The most obvious application of the results above comes from considering a family of utility functions showing increased risk aversion. Then, by Theorem 4,<sup>27</sup>

EXAMPLE 1. Of two individuals with the same wealth, the more risk averse has a lower absolute value of security holding.

The focus of much of the attention in this area has been on the implications of changing initial wealth for security holdings. We can obtain the well-known relationships of the derivatives of security holding to wealth as corollaries to Example 1 by identifying  $w$  with the index of risk aversion.

To match the notation of this section with that of Theorem 4, let us pair  $(w(1 + m), s, (i - m))$  with  $(\rho, \alpha, \theta)$  and set  $U(\alpha, \theta)$  equal to  $sr$ , the (random) return on security holdings; thus writing  $V(U, \rho)$  as  $B(w(1 + m) + U)$ . Then  $-V_{UU}/V_U$  equals the index of absolute risk aversion. We have then

COROLLARY 1. *The absolute value of security holdings increases (decreases) with wealth if absolute risk aversion decreases (increases) with wealth.*

One aspect of the approach we have taken is that the index of relative risk aversion also arises from the concavity property upon examining the fraction of wealth held in risky securities, which we denote by  $\hat{s}$ . We now write utility as

$$B(w(1 + m + \hat{s}(i - m)))$$

If we identify  $(w, \hat{s}, i - m)$  with  $(\rho, \alpha, \theta)$  and set  $U(\alpha, \theta)$  equal to  $1 + m + \hat{s}(i - m)$  the gross rate of return on total wealth, then  $V(U, \rho)$

<sup>27</sup> Clearly  $\partial B/\partial s = (i - m)B' = U_\alpha$  changes sign only once.  $(\partial B/\partial i) = sB' = U_\theta$  is signed by the sign of  $s$ . Since a negative value of  $U_\theta$  reverses the sign of the effect of  $\rho$  on  $\alpha^*$  in Theorem 3, we find that  $s$  decreases or increases as it is positive or negative. Thus the absolute level of security holdings,  $|s|$ , decreases.

becomes  $B(wU)$ . The concavity condition,  $-\partial^2 \ln V_U / \partial U \partial \rho$ , is equal to the derivative of the index of relative risk aversion. Thus we have

**COROLLARY 2.** *The absolute value of the fraction of security holdings increases (decreases) with wealth if relative risk aversion decreases (increases) with wealth.*

We have now considered three applications of Theorem 4 relating choice to risk aversion. Now let us turn to the effects of change in the distribution of the random variable.

**EXAMPLE 2.**<sup>28</sup> A mean utility preserving increase in risk decreases the absolute value of security holdings if  $P_x(\alpha\theta, w(1+m)) > 0$ .

Identifying  $(s, i-m)$  with  $(\alpha, \theta)$ , it is straightforward to check that  $P_x$  and condition (15) of Theorem 2 have opposite signs. From the relations among risk aversion indices, one can see that a sufficient condition for  $P_x$  to be positive is that absolute risk aversion be decreasing and relative risk aversion increasing. Thus we have

**COROLLARY 3.** *If the consumer has decreasing absolute risk aversion and increasing relative risk aversion, then the absolute value of security holdings decreases with a mean utility preserving increase in risk.*

## 6. TAXATION AND PORTFOLIO CHOICE

One change in the distribution of returns which is easily parametrized is that induced by tax change. Tax structures vary in their loss offset provisions and in the tax rates on the returns to different assets (e.g. capital gains as opposed to interest income); we consider the effects of changes in each of these. We assume that holdings of each asset and the safe rate of return are nonnegative ( $m \geq 0, s \geq 0, w-s \geq 0$ ). We begin with the cases of full and no loss offsets, before turning to more complicated partial offsets. To explore tax rate changes, we shall write utility as a function of the tax rate with a given distribution of before tax returns and examine demand changes by exploring taxes as indices of risk aversion. To compare tax structures we shall compare the distributions of after tax rates of return.

We denote the tax rates on the two incomes by  $t_i$  and  $t_m$ . With full loss offset we can write utility of after tax terminal wealth as

$$B(w + si(1 - t_i) + (w - s)m(1 - t_m)) \quad (44)$$

<sup>28</sup> Since  $(i-m)$  must change sign to satisfy the first order condition,  $P_x$  negative through the relevant values of  $\theta$  is not possible.

With no loss offset, we would write utility as

$$B(w + s \text{Min}(i(1 - t_i), i) + (w - s)m(1 - t_m)) \quad (45)$$

It is straightforward to check that the partial risk aversion measure indicates whether  $t_i$  is an index of risk aversion. Thus we have

EXAMPLE 3.<sup>29</sup> With full loss offset, risky security holdings increase with the tax rate on the return to the risky asset if partial risk aversion is increasing, for all  $i$  in the relevant range, i.e. if  $P_x(x, y) > 0$  with  $x = si(1 - t_i)$  and  $y = w + (w - s)m(1 - t_m)$ . The same proposition holds with no loss offset under the slightly weaker condition that  $P_x$  is positive throughout the relevant range of positive rates of return,  $i$ .

To compare the different offset rules, let us denote the after tax return by  $i'$  and write utility as

$$B(w + si' + (w - s)m(1 - t_m))$$

If the distribution of the before tax return is  $F(i)$ , with full loss offset the distribution of after tax return satisfies

$$G(i', t^f) = F(i'/(1 - t^f)) \quad (46)$$

With no loss offset the distribution of after tax return satisfies

$$\begin{aligned} H(i', t^n) &= F(i') & i' &\leq 0 \\ &= F(i'/(1 - t^n)) & i' &\geq 0 \end{aligned} \quad (47)$$

where we distinguish tax rates in the two cases by  $t^f$  and  $t^n$ . If the two tax structures are to yield the same expected utility  $t^f$  must exceed  $t^n$ . Thus this change in tax structure and rates satisfies the single crossing property, with the loss offset giving the less risky distribution; hence using the result of Example 2, we obtain

EXAMPLE 4. If partial risk aversion is increasing a tax on the risky asset with full loss offset results in a higher level of security holdings than an equal expected utility tax with no loss offset (but a lower tax rate). In addition, expected tax revenue is higher with a full loss offset in this case.

<sup>29</sup> This example shows clearly the limitation on the possibility of a negative  $P_x$ . With  $m = 0$  and full loss offset it is clear from the utility function that  $s^*(1 - t_i)$  is constant independent of the shape of  $B$ . Thus the reversed conclusion of the example would never occur for this case.

To prove the second part of the example, it is sufficient to show that expected government revenue per unit invested is higher with full loss offset and these tax rates. If the tax rates were adjusted to keep expected revenue per unit of investment (and thus the expectation of  $i'$ ) constant, the change would be mean preserving rather than mean utility preserving. Thus expected utility would be lower with the riskier distribution, the case with no loss offset. To equate expected utilities, the tax rate without loss offset must be lowered, reducing expected revenue per unit invested.

To consider limited loss offsets, let us assume that both income sources are taxed at the same rate and losses on the risky asset may be offset against returns on the safe asset. In addition we shall allow partial off-setting of any remaining losses against initial wealth (or equivalently safe non-investment income). Let us denote by  $Y$  the level of before tax income

$$Y = si + (w - s)m \quad (48)$$

The distribution of  $Y$  depends on the distribution of  $i$  and the choice of  $s$

$$G(Y, s) = F((Y - (w - s)m)/s) \quad (49)$$

Let us note that

$$G_s = ((wm - Y)/s^2) F' \quad (50)$$

so that the distribution satisfies the single crossing property. Let us assume that some fraction of remaining losses,  $f$ ,  $0 \leq f \leq 1$ , can be set off against initial wealth. Then, we can write utility as

$$B(w_0 + \text{Min}(Y(1 - t), Y(1 - ft))) \quad (51)$$

We can now examine the response to changes in  $f$  and  $t$ . By the corollary to Theorem 2 we have

**EXAMPLE 5.** With partial loss offset, if tax rates and offset fraction are adjusted to keep equal expected utility, risky security holdings increase with the tax rate and the offset fraction if partial risk aversion is increasing.

Since the tax rate and offset fraction must both increase to keep expected utility constant, it is clear that risky security holdings are larger with complete loss offset than with an equal expected utility partial loss offset, provided that  $P_\sigma$  is positive.

## 7. COSTS OF MEETING RANDOM DEMAND

Consider a firm with a concave production function  $F(K, L)$  (with positive marginal products) which selects  $K$  ex ante and  $L$  ex post to meet a random demand  $Q$  in order to maximize the expectation of utility of costs  $\int B(rK + wL) dF(Q)$ . We can prove the proposition<sup>30</sup>

EXAMPLE 6. If capital and labor are complements ( $F_{KL} > 0$ ), the more risk averse the firm the greater its level of capital.

Define  $L(Q, K)$  implicitly by  $Q = F(K, L)$ . Then, identifying  $(\alpha, \theta)$  with  $(K, Q)$  we can check the condition of Theorem 4 that  $U_\alpha = B'[r + w(\partial L/\partial K)]$  has a unique value of  $Q$  for which it equals zero. This follows from the monotonicity of  $\partial L/\partial K$  in  $Q$ , given  $F_{KL} > 0$ .

$$\frac{\partial L}{\partial K} = -\frac{F_K}{F_L}, \quad \frac{\partial^2 L}{\partial K \partial Q} = F_{LL}F_KF_L^{-3} - F_{LK}F_L^{-2} < 0 \quad (52)$$

To examine the effect of an increase in risk let us consider the special case of an expected cost minimizer with a constant returns to scale, constant elasticity-of-substitution production function.

EXAMPLE 7. A mean utility (i.e., cost) preserving increase in risk increases (decreases) the level of capital if the elasticity of substitution is greater (less) than one.

Again the calculations are straightforward, but tedious. Let  $Q/K = F(1, L/K) = f(l)$ . The elasticity of substitution  $\sigma$ , is given by

$$\sigma = -f'(f - lf')/ff''l$$

Let  $a = (f - f'l)/f'l$ ; then, making the obvious identifications

$$\begin{aligned} U_\theta &= w(dL/dQ) = wF_L^{-1} = wf'^{-1} \\ U_{\alpha\theta} &= wf''fK^{-1}f'^{-3} = aw\sigma^{-1}K^{-1}f'^{-1} \\ U_{\theta\theta} &= -wf''K^{-1}f'^{-3} \\ -U_{\alpha\theta\theta} &= \frac{aw}{\sigma} (f''f'^{-3}K^{-2}) - \frac{w}{Kf'} \frac{d(a/\sigma)}{dQ} \end{aligned}$$

Thus we have

$$U_\theta U_{\alpha\theta\theta} - U_{\alpha\theta} U_{\theta\theta} = \frac{w^2}{Kf'^2} \frac{d(a/\sigma)}{dQ} = \frac{w^2}{Kf'^2} \frac{d(a/\sigma)}{dl} \left( \frac{1}{Kf'} \right) \quad (53)$$

With  $\sigma$  constant  $a$  decreases (increases) with  $l$  when  $\sigma$  is greater (less) than one.

<sup>30</sup> If there are constant returns to scale,  $F_{KL}$  is always positive.

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